

Liquidated Damages in California Commercial Real Estate

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This article is part of the project undertaken by ACREL's Acquisitions Committee to analyze on a state-by-state basis the alternative remedies available to sellers for breach of a commercial real estate purchase contract.² This article summarizes California law as to each of the questions posed by the Committee.

I. May the seller choose specific performance instead of liquidated damages (so that liquidated damages are not an exclusive remedy)?

Most contracts for the purchase and sale of commercial real estate governed by California law provide for liquidated damages for the buyer's breach of its obligation to purchase. Most of those contracts provide that the recovery of liquidated damages is the seller's *exclusive remedy* for such a breach. When a contract for the purchase and sale of commercial real estate in California provides for liquidated damages for the buyer's breach, but does not specify that liquidated damages are the seller's *exclusive remedy*, California law is clear that a seller may choose specific performance instead of liquidated damages. As stated in Witkin's Summary of California Law:

[A] liquidated damage provision does not deprive the seller of his or her election to seek specific performance rather than damages . . .³

Two California statutes support this conclusion -- the first providing that contracts may be specifically enforced, even if the damages have been liquidated for its breach, and the second providing that nothing in California's liquidated damages statute⁴ (discussed in detail in Section V) affects a party's right to obtain specific performance:

- **Cal. Civ. Code §3389:** "A contract otherwise proper to be specifically enforced, may be thus enforced, though a penalty is imposed, or the damages are liquidated for its breach, and the party in default is willing to pay the same."⁵
- **Cal. Civ. Code §1680:** "Nothing in this chapter affects any right a party to a contract for the purchase and sale of real property may have to obtain specific performance."⁶

The Law Revision Commission Comments (hereinafter the Commission's Comments) to California's liquidated damages statute note that "Section 1680 makes clear that this chapter

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² See Stevens A. Carey, *Liquidated Damages in a Real Estate PSA: A Closer Look*, PRAC. REAL ESTATE LAW., Jan. 2019, at 24.

³ 1 WITKIN, SUMMARY OF CALIFORNIA LAW 11th *Contracts* § 549 (2018).

⁴ CAL. CIV. CODE §§ 1671–1681 (West 2019).

⁵ *Id.* § 3389.

⁶ *Id.* § 1680

[governing the liquidation of damages] does not affect the rule under existing California law that the right of the seller to obtain specific performance of a contract for the purchase of real property is not affected by the inclusion in the contract of a provision liquidating the damages to the seller if the buyer defaults on his agreement to purchase the property.”⁷

II. May the seller choose actual damages instead of liquidated damages (so that liquidated damages are not an exclusive damage remedy)?

California’s liquidated damages statute sets forth the requirements for a valid liquidated damages provision in a real estate contract, but does not expressly address whether, assuming the contract does not provide that liquidated damages are the seller’s exclusive remedy, a seller would have the right to choose between liquidated damages specified in such a contract and the seller’s actual damages. There also does not appear to be any legislative commentary or reported California cases that *directly* address the enforceability of an optional liquidated damage provision in a commercial real estate contract.

The Statute

As discussed in more detail in Section VI, under California’s liquidated damages statute, a provision in a commercial real estate contract liquidating damages for breach is valid unless the party seeking to invalidate the provision establishes that the provision was “unreasonable under the circumstances existing at the time the contract was made.”⁸ The former statute provided that the parties to a contract may agree upon a liquidated damages amount only when “it would be impracticable or extremely difficult to fix the actual damage.”⁹ Under that statutory regime, it would have been reasonable to assume that a valid liquidated damages clause would be a seller’s sole and exclusive remedy because such a clause was intended to allow parties to “know with reasonable certainty the extent of liability for a breach of the agreement” as noted in *Better Food Markets v. American Dist. Tel. Co.*¹⁰ In 1977, the California legislature repealed the then-existing liquidated damages statute, however, and replaced it with the current statute, which no longer explicitly requires that it be “impracticable or extremely difficult to fix the actual damage.” Rather, as discussed in more detail in Section VI, the current statute simply requires that a liquidated damages provision be reasonable under the circumstances existing at the time the contract was made. As such, the current California liquidated damages statute would likely be interpreted differently by a court today than the prior statute was in *Better Food Markets*; and, therefore, whether a seller could choose actual damages instead of liquidated damages is an open question. Certainly, a provision in a real estate contract permitting a seller to choose between liquidated damages or actual damages is not expressly prohibited by the current statutory regime.

The Commentary

The 1976 annual report of the California Law Revision Commission (hereinafter the Commission’s Report) recommended revisions to the liquidated damages statute based on its findings that liquidated damages clauses are useful and should be encouraged, particularly when

⁷ ANN. REP., 13 CAL. L. REVISION COMM’N 1601, 1758–1759 (1976).

⁸ CAL. CIV. CODE § 1671(b) (West 2019).

⁹ CAL. CIV. CODE § 1671 (1872) (amended by 1977 Cal. Stat. 718).

¹⁰ *Better Food Mkts. v. Am, Dist. Tel. Co.*, 40 Cal. 2d 179, 184 (1953).

the contracting parties had relatively equal bargaining power.¹¹ Based on those recommendations, the California legislature modified the liquidated damages statute in 1977¹², eliminating the requirement for enforceability that the actual damages be “impracticable or extremely difficult to fix”, and imposing only a requirement that a liquidated damages clause be “reasonable under the circumstances at the time the contract was made”. In making its recommendations, the Law Revision Commission did not expressly take a position on whether a contract having an enforceable liquidated damages provision could allow a seller to choose between the amount of liquidated damages stated in the contract and the actual damages suffered by the seller.¹³

The Case Law

There are two reported cases which may support a California court honoring the parties’ agreement to provide an aggrieved party an option to pursue actual damages or to receive liquidated damages. In *Royer v. Carter*, a contract for the purchase of a residential property provided for a deposit and stated that “should the purchaser fail to pay the balance of the purchase price, or fail to complete the purchase, as herein provided, the amount paid hereon may, at the option of seller, be retained as consideration for the execution of this agreement by seller.”¹⁴ Citing the liquidated damages statute, the court stated:

The retention of the deposit was not ... inconsistent with plaintiff’s right to elect to hold defendant responsible for damages. Independently of any rights she may have had under the option clause itself ... plaintiff had the alternative right to retain the down payment as a setoff against her actual damages... Her retention of the money was consistent with the choice of either remedy. Since she informed defendant of her intention to hold defendant liable for actual damages, if the later did not perform the contract, and since her conduct was not inconsistent with the election of that remedy, the trial court was justified in finding that the ‘deposit was retained by her to apply on damages sustained by reason of defendant’s breach of contract.’¹⁵

Although citing the liquidated damages statute in its ruling, the court in *Royer* did not evaluate whether the parties intended to liquidate damages or if the contract language constituted

¹¹ See ANN. REP., 13 CAL. L. REVISION COMM’N 1601, 1740–1741 (1976). The Commission’s Report relied heavily on a background study of liquidated damages provisions prepared for the Law Revision Commission by Justin Sweet. Justin Sweet, *Liquidated Damages in California*, 60 CAL. L. REV. 84 (1972). The Commission’s Report citing the Sweet Article noted that parties include liquidated damages provisions to avoid costs, difficulty and delay in proving damages in court; that parties may avoid perceived inequities of the normal rules of damages; that liquidated damages provisions may provide an incentive to perform if there is certainty as to damages; and that liquidated damages provisions should be encouraged where parties have equal bargaining power.

¹² ANN. REP., 13 CAL. L. REVISION COMM’N 1601, 1739 (1976). The Commission’s Report was adopted by the Legislature without change, *Guthman v. Moss*, 150 Cal. App. 3d 501, 510 (1984), and is therefore given substantial weight when interpreting Section 1671.

¹³ *But see* Sweet, *supra* note 11, at 143 (“[O]nly in those rare cases where the trial judge is confident that the evidence will clearly establish the actual damages with minimal expenditure of judicial effort should the [liquidated damages] clause not be enforced.”).

¹⁴ 37 Cal. 2d 544, 546 (1951).

¹⁵ *Id.* at 547.

a valid liquidated damages provision. It is worth noting that the contract language did *not* use the words “liquidated damages.” It provided that the deposit “may, at the option of seller, be retained *as consideration* for the execution of this agreement.” Entered into in 1948 prior to the liberalizing 1977 amendments, the liquidated damages statute in effect at the time of the *Royer* contract permitted enforcement of a liquidated damage clause only where actual damages “would be impracticable or extremely difficult to fix.” The *Royer* court may have glossed over the deficiencies of the contract as including a valid liquidated damages provision since the seller was pursuing actual damages. The Sweet Article (upon which the Law Revision Commission relied heavily) details the contracting practice at the time the *Royer* contract was executed when sellers sought to retain deposits by declaring them as “earned consideration” or “separate consideration for entering into the contract” as a means to get around the strict liquidated damages statute and disfavored treatment of liquidated damages by some courts.¹⁶ If the seller in *Royer* had sought to retain the deposit as liquidated damages, the court may have reached a different ruling given unfavorable treatment under existing case law of the “consideration-for-entering-the-contract fiction.”¹⁷ With this background, reliance on the *Royer* decision as supporting an optional liquidated damages provisions is questionable.¹⁸

Another ruling by a California court may provide support for upholding an optional liquidated damage provision – although not in the purchase and sale context. In *El Centro Mall, LLC v. Payless ShoeSource, Inc.*,¹⁹ the contract at issue was a commercial lease that included a term providing that, if the tenant failed to operate its business in accordance with the lease, the landlord would be entitled to “an additional charge” that constituted a “liquidated sum representing the minimum damages which Landlord is deemed to have suffered.”²⁰ The additional charge was “without prejudice to Landlord’s right to claim and prove a greater sum of damages.”²¹ The tenant argued that the damages provision was an unenforceable penalty and that the provision did not accurately represent a forecast of damages and was therefore unreasonable at the time it was made.²² The tenant did not argue that the provision was an invalid optional liquidated damages provision. Without passing on that specific issue, the court upheld the liquidated damages provision as generally valid. It is unclear, however, whether the court would have allowed the landlord to seek actual damages in excess of the liquidated sum.

¹⁶ Sweet, *supra* note 11, at 95–100.

¹⁷ *Id.* at 97–99; *see also* Caplan v. Schroeder, 56 Cal. 2d 515 (1961).

¹⁸ *See* Silver Star Alpine Meadows Dev. v. Quinlan, No. A145358, 2016 WL 6649201, at *3–*4 (Cal. Ct. App. Nov. 10, 2016) (noting that a clause permitting release of a deposit to seller as a “genuine pre-estimate of damages” upon termination of the contract was not a liquidated damages clause as the buyer attempted to argue); *but see* Ravenstar v. One Ski Hill Place, 401 P.3d 552, 557 n.5 (Colo. 2017) (the Colorado Supreme Court stating: “Other courts have similarly turned to freedom of contract principles to determine that granting a non-breaching party a contractual option to pursue liquidated damages does not waive the party’s option to alternatively pursue other remedies, even if the remedies were not specifically preserved in the contract.”); *see, e.g., Royer*, 37 Cal. 2d at 548 (holding that the presence of a liquidated damages clause did not prevent the seller from seeking actual damages because the buyer “did not enter into the contract under the mistaken belief that the clause giving an optional remedy to [the seller] also limited [the buyer’s] liability”). The statement by the *Ravenstar* court that the contract in *Royer* included a liquidated damages clause is disputable as discussed in this article.

¹⁹ 174 Cal. App. 4th 58 (2009).

²⁰ *Id.* at 61.

²¹ *Id.*

²² *Id.*

III. If the seller may choose liquidated damages or actual damages, may it have both?

If a California court were to permit a seller to choose between liquidated damages and actual damages, it would not permit a seller to recover both because such payment would constitute a penalty.²³

IV. If the seller may choose liquidated damages or actual damages, but not both, when must it decide?

If the *Royer* decision supports a seller's option to elect liquidated damages or actual damages, it is not instructive as to when such election must be made. *Royer* states that "plaintiff had the alternative right to retain the down payment as a setoff against her actual damages" and "the retention of the money was consistent with the choice of either remedy."²⁴ This language addresses the right to retain the deposit as liquidated damages or as a set off against actual damages, but does not state when the seller must choose. In the *El Centro Mall* decision, since the court did not address whether the liquidated damages clause at issue constituted an optional liquidated damage clause or otherwise permitted the pursuit of additional damages, there was no discussion in the opinion as to the timing for making such elections.

V. Is there an applicable statute addressing liquidated damages clauses?

California liquidated damages law is codified in Title 4.5 of the California Civil Code. The general rule is stated in Section 1671. Sections 1675, *et seq.* specifically govern a buyer's default²⁵ in real estate contracts. Section 1676 sets forth the requirements for valid liquidated damages provision in commercial²⁶ real estate purchase contracts :

Except as provided in Section 1675, a provision in a contract to purchase and sell real property liquidating the damages to the seller if the buyer fails to complete the purchase of the property is valid if it satisfies the requirements of Section 1677 and the requirements of subdivision (b) of Section 1671.

The specific requirements of Sections 1677 and 1671(b) are discussed in Section VI.

VI. What is the test for a valid liquidated damages clause?

As provided in California Civil Code Section 1676, to be valid, a liquidated damages clause must satisfy the requirements of Sections 1677 and Section 1671(b).

²³ See *McGuire v. More-Gas Invs., LLC*, 163 Cal. 3d 225 (2013).

²⁴ *Royer*, 37 Cal. 2d at 547.

²⁵ If a contract contains a provision providing liquidated damages for a seller's defaults, the enforceability of that provision is governed by the general rule stated in Section 1671. Civil Code Section 1679 expressly provides: "This chapter [sections 1675, *et seq.*] applies only to a provision for liquidated damages to the seller if the buyer fails to complete the purchase of real property. The validity of any other provision for liquidated damages in a contract to purchase and sell real property shall be determined under Section 1671."

²⁶ Liquidated damages provisions applicable to a buyer's default under residential contracts are governed by Civil Code section 1675.

Section 1671(b)

The more substantive of the two sections – Section 1671(b) – provides that a liquidated damages provision in a commercial real estate contract is valid “unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made.” The liquidated damages statute of the 1872 Civil Code provided a more stringent standard for enforcement which was subsequently amended in 1977. Prior to the 1977 amendments, the Civil Code permitted enforcement of a liquidated damages provision only where the actual damages “would be impracticable or extremely difficult to fix.”²⁷ The courts expanded the 1872 statutory provisions to add a requirement that, at the time the contract was entered into, “the sum agreed upon represented a reasonable endeavor to ascertain what such damages would be.”²⁸ In 1977, the California legislature adopted the Law Revision Commission’s recommendations set forth in the Commission’s Report which amended Section 1671 effective as of July 1, 1978 and adopted a general rule favoring the enforcement of liquidated damages provisions except with respect to consumer matters.²⁹ The court in *Krechuniak v. Noorzoy* citing *Ridgley v. Topa Thrift & Loan Association*³⁰ summarized the amendments to the statute:

In *Ridgley v. Topa Thrift & Loan Assn* [full citation omitted], the California Supreme Court explained: “California law has ... long recognized that a provision for liquidation of damages for contractual breach ... can under some circumstances be designed as, and operate as, a contractual forfeiture. To prevent such operation, our laws place limits on liquidated damages clauses. Under the 1872 Civil Code, a provision by which damages for a breach of contract were determined in anticipation of breach was enforceable only if determining actual damages was impracticable or extremely difficult. (1872 Civ. Code, §§ 1670, 1671.) As amended in 1977, the Code continues to apply that strict standard to liquidated damages clauses in certain contracts (consumer goods and services, and leases of residential real property (§ 1671, subds. (c), (d)), but somewhat liberalizes the rule as to other contracts: ‘[A] provision in a contract liquidating the damages for breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made.’³¹

Despite the liberalizing of the rules for commercial real property contracts effective as July 1, 1978, many liquidated damages clauses in commercial real estate contracts continue to recite an acknowledgement by the parties that the seller’s actual damages in the event of a failure to consummate the sale due to a buyer’s default would be impracticable or extremely difficult to determine.

Other factors identified in the Commission’s Report for determining whether a liquidated damage provision is reasonable include the relationship that the contract damages bear to the

²⁷ CAL. CIV. CODE § 1671 (1872) (amended by 1977 Cal. Stat. 718).

²⁸ *McCarthy v. Tally*, 46 Cal. 2d 577, 586 (1956).

²⁹ *Krechuniak v. Noorzoy*, 11 Cal. App. 5th 713 (2017).

³⁰ *Ridgley v. Topa Thrift & Loan Ass’n*, 17 Cal. 4th 970, 976–977 (1998).

³¹ *Krechuniak*, 11 Cal. App. 5th at 720.

range of harm that reasonably could be anticipated at the time of the making of the contract , the relative equality of the bargaining power of the parties, whether the parties were represented by lawyers at the time the contract was made, the anticipation of the parties that proof of actual damages would be costly or inconvenient, the difficulty of proving causation and foreseeability, and whether the liquidated damages provision is included in a form contract.³²

Section 1677

The other statutory requirement for a valid liquidated damages clause—Section 1677—sets forth mechanical requirements for the execution and print size of a liquidated damages provision. The requirements apply only to provisions for liquidated damages “to the seller if the buyer fails to complete the purchase.” The liquidated damages provision is invalid unless it “is separately signed or initialed by each party to the contract” and, if included in a printed contract, it “is set out either in at least 10-point bold type or in contrasting red print in at least eight-point bold type.” The Commission’s Comments to Section 1677 explain that the purpose of the execution and the print requirements is to make it more likely that the parties will appreciate the consequences of the liquidated damages provision.³³

VII. Who has the burden of proof?

The party with the burden of proof is the party seeking to invalidate the liquidated damages provision.³⁴

VIII. As of when is “reasonableness” tested?

The reasonableness of a liquidated damages provision is determined by “the circumstances existing at the time the contract was made.”³⁵ The Commission’s Comments to Section 1671(b) support this forward-looking test:

The subdivision limits the circumstances that may be taken into account in the determination of reasonableness to those in existence “at the time the contract was made.” The validity of the liquidated damages provision depends upon its reasonableness at the time the contract was made and not as it appears in retrospect. Accordingly, the amount of damages actually suffered has no bearing on the validity of the liquidated damages provision.³⁶

The recommendations in the Commission’s Report reinforces this intent:

Reasonableness should be judged in light of the circumstance’s confronting the parties at the time of the making of the contract and not by the judgement of hindsight. To permit consideration of the damages suffered would defeat one of

³² ANN. REP., 13 CAL. L. REVISION COMM’N 1601, 1751–1752 (1976).

³³ *But see Guthman*, 150 Cal. App. 3d at 501 (interpreting the requirements of section 1677 to be solely for the protection of the buyer).

³⁴ CAL. CIV. CODE § 1671(b) (2019).

³⁵ *Id.*

³⁶ ANN. REP., 13 CAL. L. REVISION COMM’N 1601, 1751 (1976).

the primary purposes of liquidated damages which is to avoid litigation of the amount of actual damages.³⁷

IX. What percentage of the purchase price is likely acceptable as liquidated damages?

For commercial real estate contracts, there is no safe harbor or cap on the percentage of the purchase price that would satisfy the “reasonableness test” under the California liquidated damages statute.³⁸ In practice, the liquidated damages amount is usually the amount of the deposit, but there is no customary percentage of the purchase price for the deposit amount.

X. Are actual damages relevant for liquidated damages and, in particular, will liquidated damages be allowed when there are no actual damages?

Under California law, actual damages should not be relevant in determining whether a liquidated damages provision is valid. Section 1671(b) of the Civil Code requires liquidated damages to be a reasonable estimate of damages “under the circumstances at the time the contract was made.” As such, the “amount of damages actually suffered has no bearing on the validity of the liquidated damages provision.”³⁹

If valid under the “reasonableness test” of Section 1671(b), liquidated damages should be available even if there are no actual damages. However, one California case potentially supports a contrary view. In *Kuish v. Smith*,⁴⁰ the buyers contracted to purchase a home for \$14,000,000 and made two deposits totaling \$620,000 toward the payment of the purchase price. The buyer later cancelled the contract and the sellers thereafter quickly sold the home for \$15,000,000. The contract did not contain a liquidated damages provision but did describe the deposits as “non-refundable.” The sellers sought to retain the deposit arguing that the use of the term “non-refundable” entitled them to do so. The *Kuish* court held that permitting the sellers to retain the deposit would result in an unlawful “forfeiture” and explained:

In the context of a rising market, which was the circumstance of the instant case, an interpretation of the nonrefundable term of the agreement as precluding the return of plaintiff's deposit above and beyond any damages suffered by defendants as a result of plaintiff's breach would render that provision unenforceable. As discussed ante, “ ‘any provision by which money or property would be forfeited without regard to the actual damage suffered would be an unenforceable penalty.’ ”⁴¹

The holding of *Kuish* court would likely be different if the contract expressly provided that the deposits were liquidated damages.

³⁷ *Id.* at 1742.

³⁸ In residential real estate contracts, if the amount paid as liquidated damages does not exceed 3% percent of the purchase price, it is valid “to the extent actually paid unless the buyer establishes that the amount is unreasonable.” CAL. CIV. CODE § 1675(c) (West 2019). If the amount paid exceeds 3%, it “is invalid unless the party seeking to uphold the provision establishes that the amount actually paid is reasonable.” *Id.* § 1675(d).

³⁹ ANN. REP., 13 CAL. L. REVISION COMM’N 1601, 1751 (1976).; *Hong v. Somerset Assocs.*, 161 Cal. App. 3d 111, 115 (1982).

⁴⁰ 181 Cal. App. 4th 1419 (2010).

⁴¹ *Id.* at 1429.

XI. Is mitigation relevant for liquidated damages?

If actual damages have no bearing on the validity of liquidated damages, then the seller's attempt or lack of attempt to mitigate its damages should be irrelevant (although potential mitigation steps that are apparent at the time of the contract may be taken into account in determining what is reasonable).

XII. Is a "Shotgun" liquidated damages clause enforceable?

There is no reported California case that specifically addresses a "shotgun" clause in which a seller is permitted to receive liquidated damages for any default by a buyer under a real estate contract, whether or not such default is material. Because of the "reasonableness test" of the California liquidated damages statute, a "shotgun" clause would likely not be enforceable for an immaterial breach. Permitting liquidated damages for an immaterial breach would be unreasonable since "it bears no reasonable relationship to the range of actual damages that the parties could have anticipated would flow from [such] breach."⁴²

XIII. Does a liquidated damages clause preclude recovery of attorneys' fees by the seller?

A liquidated damage clause does not preclude recovery of the attorneys' fees. Most commercial real estate contracts include a provision giving a prevailing party the right to payment of its attorney fees by the defaulting party and many expressly carve out from the liquidated damages amount the payment of such fees. In *Zlotoff v. Tucker*, a California court upholding a liquidated damages provisions in a real estate contract awarded attorneys' fees.⁴³

⁴² *Ridgley*, 17 Cal. 4th at 977.

⁴³ *Zlotoff v. Tucker*, 154 Cal. App 3d 988, 995 (1984).